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Before the
FEDERAL COMMUNICATIONS COMMISSION
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JUN 29 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

GTE's COMMENTS IN OPPOSITION TO PETITIONS FOR RECONSIDERATION

GTE Service Corporation and its affiliated domestic telephone operating companies

Richard McKenna, HQE03J36
GTE Service Corporation
P.O. Box 152092
Irving, TX 75015-2092
(214) 718-6362

Gail L. Polivy
1850 M Street, N.W.
Suite 1200
Washington, DC 20036
(202) 463-5214

June 29, 1995

Their Attorneys

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SUMMARY

1. All three *Petitioners* raise once again the very same arguments that were thoroughly briefed in their earlier submissions, including numerous *ex parte* submissions. *Petitioners* add nothing new to the established record, nothing that changes the facts upon which the Commission based its decision to establish interim price cap rules governing Local Exchange Carriers ("LECs" or "exchange carriers").

2. GTE urges the Commission to deny the *Petitioners*' requests for a higher productivity factor for the interim period. *Petitioners* will have ample opportunity to add information to the record that substantiates their position in the course of the forthcoming further notice on the LEC price cap plan.

3. The Commission has correctly reached the tentative conclusion that the X-Factor should be calculated on a total company basis. Ad Hoc's arguments to the contrary are not only flawed, but inconsistent. At the federal level, Ad Hoc wants an X-Factor based on jurisdictional separations and at the state level on TFP. Further, Ad Hoc argues for jurisdictional separation of productivity but a total company measure of inflation. The Commission should deny Ad Hoc's request to base productivity on interstate-only data.

4. To carry out its statutory charter of ensuring just and reasonable rates, the Commission is not obliged to retain sharing. This is reemphasized by the fact that sharing is not required for AT&T. The Commission is pursuing its stated course of promoting incentives for greater efficiency by eliminating sharing.

5. GTE urges the Commission to deny Petitioners' requests for the elimination of LFAM. There is no basis for their assertion that LECs have somehow contrived to benefit from a lower formula adjustment.

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GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE") submit these comments in opposition to the Petitions for Reconsideration[1] filed by AT&T, MCI, and Ad Hoc ("*Petitioners*") in the captioned proceeding with reference to the *First Report & Order*[2]; and urges the Commission to deny them.

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1 *See* AT&T's Petition for Limited Reconsideration or, in the Alternative, Clarification ("*AT&T Petition*"); MCI's Petition for Reconsideration ("*MCI Petition*"); Ad Hoc's Petition for Expedited Partial Reconsideration ("*Ad Hoc Petition*"), CC Docket No. 94-1, dated May 19, 1995.

2 *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1 ("*D.94-1*"), First Report and Order, FCC 95-132 (released April 7, 1995) (the "*First Report & Order*"), *petition for review filed sub nom.* Bell Atlantic Operating Companies v. FCC, No. 95-1217 (D.C. Cir. filed April 19, 1995).

DISCUSSION

PART ONE: PRODUCTIVITY ISSUES

I. THE RECORD DOES NOT SUPPORT *PETITIONERs'* PROPOSED PRODUCTIVITY FACTORS.

AT&T, MCI, and Ad Hoc ask the Commission to reconsider the productivity or X-Factor options established in the *First Report & Order* and increase them. GTE will not respond to these repetitive arguments in detail since ample rebuttal already exists in the record and the Commission has already rejected them. GTE adds a few supplementary points *infra.*

1. AT&T's arguments that the FCC should revise LEC productivity offsets to reflect earnings conflicts with Commission policy and the essential nature of price caps.

AT&T (at 5) submits that the Commission should revise the productivity offsets to better "reflect the LECs' higher achieved productivity." AT&T bases this request on its previously submitted productivity study which produced an aggregate productivity of 5.54 percent based on LEC earnings.[3]

It will suffice to point out that basing a productivity offset on specific earnings levels is not price cap regulation but another form of rate of return regulation.[4] Accepting AT&T's argument would remove all pretense of a system operating under price cap principles. Further, if setting the productivity factor based on earnings were a logical part of price caps, then the Commission should have reset AT&T's 3.0 percent

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3 *AT&T Petition* at 3. AT&T (n.4) does allow for an adjustment of 0.8 percent if the Commission changes the CCL formula to a per-line methodology.

4 *See* GTE's Reply Comments at 23-26.

productivity factor under price caps based on AT&T's reported earnings exceeding 11.25 percent.[5] The FCC did not do so because this is not a logical part of price caps.

Furthermore, the Commission refused to take action on AT&T's requests (i) to compute a new and lower productivity factor based on the revised Basket 1 services or (ii) to eliminate the X-factor from the price cap formula as applied to AT&T.[6] Nor did the Commission address any changes to AT&T's productivity factor in its recently released Further Notice of Proposed Rulemaking (the "*AT&T Further Notice*") on AT&T's price cap rules.[7] In applying price cap regulation to AT&T, the Commission does not alter the productivity factor based on AT&T's earnings -- and yet this is precisely what AT&T argues should be done for exchange carriers. The Commission should reject the AT&T proposal.

2. GTE agrees with the *First Report & Order* that the Commission's record is not adequately developed to resolve the input price differential issue.

Ad Hoc (at 4) and MCI (at 4) recommend that the Commission adopt 5.7 percent as the highest optional factor. These parties base this conclusion, in part, on their interpretation of how a LEC input price differential should be calculated. This is another subject that was discussed in comments, reply comments, and *ex parte* submissions.

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5 AT&T's Returns on Investment for 1991-93 were 13.41, 12.77, and 13.49 percent respectively. *See* Southwestern Bell's Reply Comments dated June 29, 1994, at 18.

6 *See Revisions to Price Cap Rules for AT&T Corp.*, Report and Order, CC Docket No. 93-197 ("*D.93-197*"), 10 FCC Rcd 3009, 3021 (1995) (the "*D.93-197 Report & Order*").

7 *See Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313 ("*D.87-313*") and *D.93-197*, Further Notice of Proposed Rulemaking, FCC 95-198 (released May 18, 1995) (the "*AT&T Further Notice*").

The *First Report & Order* (at paragraph 161), agreeing with these parties, has tentatively concluded that an input price differential should be incorporated into a TFP-based X-Factor. However, the Commission chose not to do so in the interim because "[t]he record is not sufficiently developed to allow [the Commission] to choose a specific methodology." *Id.*

Whatever the merits of this tentative conclusion,[8] GTE agrees with the Commission that the record is not adequately developed to resolve the input price differential issue. The Commission has properly decided to explore this issue in a future further notice on the LEC price cap plan.

3. GTE agrees with MCI that the Commission should not have ignored price cap period data; but stresses that such data would not have raised but lowered the productivity factors established for the interim.

GTE agrees with MCI (at 3) that it was inappropriate for the Commission to ignore price cap period data in establishing a forward-looking productivity factor. GTE submits that a forward-looking productivity factor should be based on a five-year rolling average which includes productivity data from the most recent period of time. The *First Report & Order* (at paragraph 153) tentatively concludes that a five-year rolling average "could substantially improve the LEC price cap plan."

Given this statement and that the Commission lacks the means to implement immediately such a five-year rolling average, it should not have ignored price cap period data in setting the interim productivity factors.

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[8] GTE is among those parties asking the Court of Appeals to review this and other aspects of the *First Report & Order*.

However, contrary to MCI's allegations that incorporation of such data would have significantly raised the productivity factors established for the interim, GTE contends that it would have had the opposite effect and lowered them. As the *First Report & Order* notes (at n.298), USTA's revised study with 1993 data produces a productivity factor of 2.1 percent after adjusting for Bureau of Labor Statistics data. USTA has on the record voluminous data used by Christensen Associates to produce a LEC Total Factor Productivity ("TFP") study which was validated by National Economic Research Associates, Inc. ("NERA"). This study resulted in a productivity factor of less than the 3.3 percent selected by the Commission in the original proceeding and far below the minimum option of 4.0 percent provided for in the *First Report & Order.*[9]

4. Still further increases in productivity factors are not justified.

AT&T (at n.13), MCI (at 10-11), and Ad Hoc (at 5) all argue that the productivity options specified by the *First Report & Order* are understated. Based on this argument, they even maintain the no-sharing option must be eliminated -- a point addressed *infra*.

In fact, the record provides no support for *Petitioners'* contention that the specified productivity factors are too low. As stated *supra*, all the data submitted by USTA reflects a productivity factor much lower than that being espoused by *Petitioners*. Further, arguments advanced by *Petitioners* that the number of LECs selecting the 5.3 percent option is proof that the hurdle is too low are invalid.

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9 *See* USTA Comments dated May 9, 1994, Attachments 5 and 6; USTA's Reply Comments dated June 29, 1994, Attachment 4; Letter dated January 20, 1995 from Mary McDermott, USTA, to William F. Caton, Acting Secretary, adding 1993 LEC data to the Christensen study.

The Commission sought to accommodate LEC heterogeneity by establishing three productivity options with sharing eliminated on the highest option. Ad Hoc (at 5), AT&T (at 4), and MCI (at 5) each discuss the productivity choices of the LECs and conclude not only that the Commission's options are flawed because more LECs chose 5.3 but also that 5.3 percent is not high enough. *Petitioners* conclude that the somewhat skewed selection distribution indicates that the productivity factors were set too low. GTE believes *Petitioners* address only one dimension of a multi-dimensional decision process for exchange carriers.

With equal justice, it could be said that more companies would have chosen the sharing options had they incorporated lower productivity factors. The ts productivity estimate on which the Commission based its decision included the revised Frentrup-Uretsky study of 4.0 percent, representing an industry average.

Given the three options presented to the LECs, no inference can be made concerning long-run productivity by observing the relative choices LECs actually made. These choices were influenced by a number of factors:

1. The election was only for one year. Therefore, LECs did not have to consider their ability to met the productivity target over the long-term.
2. The choice was a relative one among the options, *i.e.*, it reflects a comparison of (i) the value of eliminating sharing and (ii) the difference in the productivity factors among the options. In other words, some LECs chose to pay 1.3 percent in productivity in order to eliminate the heavy costs and burdens of sharing.

3. The Commission's recent "*Add-Back Order*"[10] creates an additional "penalty" for any company choosing a sharing option. Perversely, because the Commission's add-back procedure does not take into account the possibility that a company might not price to its cap, it doubly penalizes a company (such as GTE) that has voluntarily priced below its cap.

Further, the Commission plans to establish a long-term methodology for determining productivity in a forthcoming further notice. To the extent that LECs' choices among the three options are relevant -- GTE does not believe they are relevant -- this would be included in this further proceeding.

In any case, the choices made by the LECs were not a part of the record on which the *First Report & Order* was based and therefore are not appropriate grounds for reconsideration.

Moreover, the choices made by exchange carriers are greatly influenced by the parameters of the Commission's revised plan. To a great degree -- and most clearly in the case of GTE -- certain choices are virtually dictated by the Commission's revised plan.

Even though GTE maintains that the overall productivity levels established by the *First Report & Order* are not attainable on a continuing and company-wide basis,

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[10] *Price Cap Regulation of Local Exchange Carriers* and *Rate of Return Sharing and Lower Formula Adjustment*, CC Docket No. 93-179, Report and Order, FCC 95-133 (released April 14, 1995) (the "*Add-Back Order*"), *appeal pending sub nom.* Ameritech Operating Companies v. FCC, No. 95-1239 (D.C. Cir., filed April 28, 1995).

GTE selected for the coming eleven months a combination of options (the 4.0 percent option selected for areas comprising 54 percent of GTE rate base[11] -- which are generally GTE's largest operating areas; the 5.3 percent option selected for the areas comprising the remaining 46 percent) that produces the least unfavorable result for GTE.

In particular, the selection of 5.3 percent for areas comprising 46 percent of GTE rate base was driven by the fact that, in these areas, the 1.3 incremental difference between 5.3 and 4.0 had less near-term harmful impact on GTE's earnings than the exogenous or Z-factor impact of sharing.

Thus, in selecting 5.3 percent, GTE is simply responding to the incentives dictated by the *First Report & Order* and the *Add-Back Order*, which attach favorable dollar consequences in very large amounts to accepting as a working parameter unrealistic productivity assumptions. This is a world apart from price caps as originally envisioned where a company would commit itself to achieving reasonably attainable objectives.

In summary: GTE urges the Commission to deny the *Petitioners*' requests for a higher productivity factor for the interim period. *Petitioners* will have ample opportunity to add information to the record that substantiates their position in the course of the forthcoming further notice on the LEC price cap plan.

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11 This includes GTE Florida, Texas, California, Washington, Hawaii and Michigan; as well as two smaller areas, Arkansas and California-West Coast.

II. THE COMMISSION IS CORRECT IN ITS TENTATIVE CONCLUSION THAT THE X-FACTOR SHOULD BE BASED ON TOTAL COMPANY PRODUCTIVITY, NOT ON INTERSTATE ONLY.

The *First Report & Order* states tentatively the appropriate conclusion that the X-Factor should be calculated on a total company basis. Ad Hoc (at 13) asks "the Commission [to] reconsider its decision to set the optional 5.3% X-Factor on the basis of company wide TFP data." Further, Ad Hoc (at 11-12) alleges (i) that interstate productivity is higher than intrastate because demand has grown faster and (ii) that interstate is less labor intensive.

The *First Report & Order* (at paragraph 159) clearly states:

> No party has argued that the production functions (the technological relationship between inputs and outputs) significantly differ for intrastate and interstate services in ways that can be readily measured or separated.

The inability to readily measure or separate state and interstate productivity is not merely the result of a lack of data or appropriate models. It is inherent in the nature of the production function itself. Since most state and interstate services are provided jointly, their productivity functions are not separable. There is simply no such thing as an "interstate input". Therefore, there cannot be a truly interstate productivity factor.

Further, the *First Report & Order* (at n.309) makes it clear that differences in demand growth alone are not sufficient to justify an interstate productivity factor:

> In light of the fact that intrastate and interstate services share common facilities, the traffic growth differential alone does not establish that it is meaningful to distinguish two different measures of productivity.

Ad Hoc (at 12-13) refers to *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930), as demanding separation of intrastate and interstate for TFP purposes, but nothing in *Smith* requires such a result.

In *Smith*, no federal action was before the Supreme Court. The Court's relevant holding concerned action by the State of Illinois in violation of the Commerce Clause of the United States Constitution. The jurisdictional holding of the case was that "interstate tolls are the rates applicable to interstate commerce," and such tolls are not "a matter for the determination either of the Illinois Commerce Commission or of the court in dealing with the order of that Commission."[12] Seeking to dispel misapprehensions of various parties concerning *Smith*, the D.C. Circuit in 1984[13] stressed:

> *Smith* dealt with jurisdiction; it held that a portion of the costs of local subscriber plant may be recovered only under the authority of a body with interstate regulatory powers.[14]

Ad Hoc is attempting to turn the *Smith* holding into a principle that says an agency may not make logical divisions of data in preparing an analysis to support a ratemaking decision when no question of jurisdictional intrusion is involved. In deciding the appropriate analytic approach to determining industry productivity, no jurisdictional question arises. The Commission is free to select and employ the best data for determining productivity for price cap purposes. Since the Commission finds interstate and intrastate "can[not] be readily measured or separated,"[15] no valid *Smith* issue arises.

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[12] *Smith*, 282 U.S. at 148.

[13] *NARUC v. FCC*, 737 F.2d 1095, 1113 (D.C. Cir. 1984).

[14] *Id.*, 737 F.2d at 1112, *footnote omitted.*

[15] *First Report & Order* at n.309.

Furthermore, Ad Hoc wants the Commission to use, as a basis for calculating an interstate productivity factor, separations rules that are both arbitrary and outdated, and that have no direct relationship to economic costs.

As GTE pointed out in its comments,[16] a properly designed productivity offset should reflect the differential between the rate of growth in TFP in the selected "yardstick" industry and the aggregate economy. Partial measures of productivity are inconsistent with the economics of price cap design because they are confined to particular outputs or inputs and do not reflect changes in the overall unit cost of production.

In any case, Ad Hoc's present position should be considered skeptically because, in state proceedings, Ad Hoc's economist -- rather than suggesting the separation of intrastate and interstate -- has consistently supported TFP.[17] Ad Hoc (at 13) is taking an inconsistent position by supporting an economy-wide measure of inflation for interest rates rather than a jurisdictional one; and then arguing for a jurisdictional measure of productivity.

In summary: The Commission has correctly reached the tentative conclusion that the X-Factor should be calculated on a total company basis. Ad Hoc's arguments to the contrary are not only flawed, but inconsistent. At the federal level, Ad Hoc wants an X-Factor based on jurisdictional separations and at the state level on TFP. Further,

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[16] *See* GTE's Comments filed May 9, 1994, Attachment A, *Regulatory Reform for Local Exchange Carriers: Competition through Regulatory Symmetry*, Statement of Dr. Mark Schankerman, at 23-24.

[17] *See* USTA's *Ex Parte*, dated March 13, 1995.

Ad Hoc argues for jurisdictional separation of productivity but a total company measure of inflation. The Commission should deny Ad Hoc's request to base productivity on interstate-only data.

III. AMPLE EVIDENCE SUPPORTS THE COMMISSION's CONCLUSION THAT THERE IS HETEROGENEITY AMONG LEC PERFORMANCES.

MCI (at 6-7) states that "[t]he Commission has no basis to suggest that LECs' past performance and choices are heterogeneous." On the contrary, the Commission has plenty of evidence that heterogeneity exists among the price cap LECs. 1994 rates of return for the twelve price cap LECs varied by over six percentage points and this range was not a result of specific one-time up-front charges as alleged by MCI (at 6).[18]

Further evidence of the heterogeneity of the price cap LECs can easily be seen by looking at such items as total interstate revenues, which ranged from less than thirty million to over three billion dollars. The number of access lines served, the geographics of serving areas (size and population density), and the presence of competition are more elements showing heterogeneity among price cap LECs.[19]

In summary: Since the Commission's record is replete with evidence of the heterogeneity of LECs, MCI's request should be denied.

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[18] MCI fails to provide any evidence that this allegation has any merit.

[19] In GTE's view, the middle productivity option should be the industry average productivity factor. If, in fact, the Commission was trying to accommodate the heterogeneity that exists among price cap LECs, then it is reasonable to assume that some would achieve less than the industry average, some close to the industry average, and the balance greater than the industry average -- the very essence of an average. To establish an average as the lowest option is ensuring that some LECs will not be able to reach it. A true range of options should have the average as the mid-point.

PART TWO: PCI ADJUSTMENTS, SHARING AND LFAM

I. THE COST OF CAPITAL IS ACCOUNTED FOR IN THE PRICE CAP FORMULA AND NO FURTHER ADJUSTMENT SHOULD BE REQUIRED.

AT&T (at 5-6) and MCI (at 17-19) seek to have the Commission further reduce the LECs' PCIs beyond the one-time reduction ordered for the X-Factor recalculation. Thus, AT&T (*id.*) says:

> Although it [the FCC] acknowledged that the LECs' cost of capital has decreased since the adoption of the LEC price cap plan, the Commission failed without explanation to revise those carriers' price cap indices to reflect the impact of that change.[20]

Specifically, AT&T (at 6) and MCI (at 17-19) want the Commission to further order a reduction to the PCIs based on changes in cost of capital.

The *First Report & Order* (at paragraph 245) correctly declines to adjust the LECs' PCIs for changes in interest rates, changes in the overall cost of capital, or the LECs' earnings levels just as it did not adjust AT&T's PCIs in its price cap review of AT&T's performance.[21]

Interest expense is an ordinary cost of doing business, is endogenous, and is accounted for in the price cap formula through the GNP-PI. Interest expense is part of the cost of capital, which is a factor price, just as labor and taxes are factor prices. If the Commission chooses to adjust interest expense/cost of capital, then it would have

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[20] *Footnotes omitted.*

[21] *D.93-197 Report & Order.* AT&T obtained its capital from the same market as did the LECs' during the price cap period. Therefore, AT&T's cost of capital was affected by the same market changes as the LECs.

to reexamine its basic methodology to decide whether other factor prices should be adjusted for changes over time.

Further, interest rates have always been, and will continue to be, subject to fluctuation. MCI (at 18) states "the Commission made no determination that this apparent increase in interest costs is anything other than a temporary increase." An analysis of interest rates over a period of many years would show that interest rates fluctuate, sometimes steadily over a period of time, sometimes with alarming alacrity. The price caps concept requires all parties to accept realities of this sort and a degree of related risk depending on whether interest rates rise or decline.

Arguing now for a downward adjustment, does MCI advocate an upward adjustment to PCIs when interest rates climb? Or does MCI take a position of pure opportunism where increases count and decreases do not?[22] And how is it MCI speaks of adjustments so selectively?

The Commission's decision not to adjust PCIs because of interest rates is logical and consistent with the concept of price caps. As GTE pointed out in its reply comments (at 9), the California Commission clarified that changes in the cost of capital are automatically adjusted for in the price cap index the same as any other particular input price.[23] If the Commission were to adjust the price cap formula to reflect changes

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[22] This kind of opportunism would not be countenanced by the courts. AT&T v. FCC, 836 F.2d 1386 (D.C. Cir. 1988), *conditional application for review en banc denied,* No. 85-1778, Slip Op. (November 2, 1988).

[23] The Public Utilities Commission of the State of California, Decision 94-06-011, June 8, 1994, at 58-59.

in the cost of capital but not other input costs, the proper mix of capital, labor, and other inputs would be distorted in the formula.

The Commission specifically selected the GNP-PI as the most representative adjustment factor reflecting "changes in the purchasing power of money."[24] Interest rate changes are already accounted for in the price cap formula. The AT&T and MCI proposals are skewed and unfair, and would conflict with the plan the Commission has adopted.

In summary: The cost of capital is an endogenous cost already reflected in the price cap formula through the GNP-PI. The Commission correctly rejected *Petitioners'* request for an interest rate adjustment, and should again reject this request.

II. PETITIONERS' REQUESTS FOR THE RETENTION OF SHARING FOR ALL PRODUCTIVITY OPTIONS REVERTS PRICE CAPS TO RATE OF RETURN REGULATION.

Price cap regulation's purpose is to limit prices not earnings. Ad Hoc (at 9) and MCI (at 13-14) allege that the Commission is violating Section 201 of the Communications Act by not limiting the earnings of LECs. Ad Hoc (at 9) states that the Commission has not ensured that LECs "will not enjoy excessive returns." MCI (at 14) accuses the Commission of gutting "the statutory requirements of Section 201 [of the Communications Act] and its provision that rates be reasonable." These arguments are without merit because:

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24 *D.87-313,* 3 FCC Rcd 3195, 3390 (1988).

First: They misinterpret and misapply Section 201 of the Communications Act as well as the Administrative Procedure Act. Section 201 regulates rates, not earnings. If sharing were required by the statute for LECs, it would surely be required in the case of AT&T which, as in the case of LECs, is subject to Section 201. In fact, the "just and reasonable rates" language of Section 201 does not lock the agency into a prescribed methodology. It is the end result that counts.[25] And there is no reason to believe that the courts today would be any more impressed with purportedly statutory arguments thrusting regulation back to "fully distributed costs" than the D.C. Circuit was in 1993.[26]

Second: The *First Report & Order* (at paragraph 254) states specifically: "We have not found that LEC rates ... were unreasonably high." The exchange carrier rates being "reasonable," there is no question that the Commission has "gutted" Section 201.

Third: MCI's arguments (at 11-12) linking sharing to dominant carrier status are invalid. MCI's argument that "[s]o long as LECs continue to be dominant, the Commission must constrain their earnings" does not fit the reality of AT&T being free from sharing. AT&T continues to be considered a dominant carrier and does not have to share any of its earnings.

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25 *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

26 *National Rural Telecom Ass'n*, 988 F.2d 174, 184 (D.C. Cir. 1993): "To the extent that MCI is obliquely making a claim that the statutory `just and reasonable' rate requirement mandates use of fully distributed costs and bars moves toward inverse elasticity prices, our precedent is squarely against it." *Citation omitted.*

Fourth: From the outset, the intent of price caps was to lead to the eventual elimination of rate regulation.[27] It is then long-established Commission policy that sharing may be eliminated.

In summary: To carry out its statutory charter of ensuring just and reasonable rates, the Commission is not obliged to retain sharing. This is reemphasized by the fact that sharing is not required for AT&T. The Commission is pursuing its stated course of promoting incentives for greater efficiency by eliminating sharing.

III. THE LOWER FORMULA ADJUSTMENT MECHANISM SHOULD ONLY BE ELIMINATED WHEN SHARING IS ELIMINATED.

AT&T (at 10) and MCI (at 15-16) claim that the Commission erred in retaining the Lower Formula Adjustment Mechanism ("LFAM"). The LFAM and sharing were part of the same "back-stop" mechanism. They are inextricably linked; the LFAM may only be eliminated when sharing is eliminated.

The Commission's reasoning was that, if an upward limit is put on earnings, protection should be provided on the downside.[28] These parties want the Commission to take away the "reward" and leave the "risk." If the LECs have been overachieving, as these parties contend, then there is no harm in allowing the LFAM to remain intact since it should never be required. But, if these parties are not correct, then the mechanism should remain to prevent confiscatory earnings.

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27 *First Report & Order* at paragraph 1.

28 *LEC Price Cap Order*, 5 FCC Rcd at 6801-6802.

The Commission[29] established a "backstop plan" to cover significant variations from the industry productivity norm caused by "regional economic booms or recessions, among other factors " since it was "difficult to determine a single, industry-wide productivity offset that will be perfectly accurate for the industry as a whole or for individual LECs or market conditions at a given time."[30] The LFAM was adopted to ensure that any individual LEC would not be subjected to "such low earnings over a prolonged period that its opportunity to attract capital and ability to provide service are seriously impaired."[31] The Commission retained its "authority and responsibility to examine the management of the LECs to ensure that the low earnings do not indicate mismanagement, fraud, or other misbehavior."[32]

Both MCI (at 16) and AT&T (at 9) claim that the LECs invoked LFAM to recoup one-time accounting charges for corporate "downsizings." GTE reflected in its earnings reengineering costs as they occurred. These costs, like any other expense, would have been a contributing factor used in calculating an interstate rate of return. If the resulting rate of return was lower than 10.25 percent, GTE would have calculated the amount of LFAM necessary to raise the return to 10.25 percent as allowed by the rules.

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29 *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, CC Docket No. 87-313 ("D.87-313"), 5 FCC Rcd 6786 (1990), and Erratum, 5 FCC Rcd 7664 (1990) ("*LEC Price Cap Order*"), *modified on recon.*, 6 FCC Rcd 2637 (1991) ("*LEC Price Cap Reconsideration Order*"), *aff'd. sub nom. National Rural Telecom Association*, 988 F.2d 174 (D.C. Cir. 1993).

30 *LEC Price Cap Order*, 5 FCC Rcd at 6801.

31 *Id.*, 5 FCC Rcd at 6802.

32 *Id.*

This adjustment would cause the PCI to increase, resulting in higher rates if the existing rates were now "out-of-band."[33]

Corporate downsizings or reengineering costs reflect management decisions that ultimately make a company more competitive, financially stronger, and more productive. Any short-run expense increases should be outweighed by the long-range benefits incurred by these types of costs. If GTE is to begin to even approach the productivity levels anticipated by the Commission in this proceeding (4.0, 4.7, and 5.3 percent), it must take the necessary steps now to reduce its cost structure. It should be recalled that improved efficiency is the key objective of the price cap program.

Fiscal responsibility must be the goal of any company, and GTE should not be penalized for trying to achieve cost savings through consolidation and downsizing where it makes good business sense to do so. Certainly, the possibility of an LFAM adjustment in its annual interstate filing is not the deciding factor in whether or not GTE consolidates some of its corporate holdings. GTE has not made these decisions lightly in the past nor does it anticipate making them lightly in the future.

In summary: GTE urges the Commission to deny Petitioners' requests for the elimination of LFAM. There is no basis for their assertion that LECs have somehow contrived to benefit from a lower formula adjustment.

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[33] Unless required by banding constraints, increases in the PCI caused by an LFAM adjustment do not automatically lead to an increase in rates. In the past, GTE has often refrained from increasing rates to the full extent permitted by LFAM adjustments.

IV. LECs ELECTING THE NO SHARING OPTION SHOULD ONLY BE REQUIRED TO SHARE FOR THE PERIOD JANUARY 1 THROUGH JUNE 30.

AT&T (at 8) asks the Commission to clarify that the 1995 sharing obligation should apply to the January-through-July time period. GTE disagrees with AT&T. The 1/11th adjustment referred to in the *1995 TRP Order*[34] placed the entire filing schedule back on a July-to-July basis. The *1995 TRP Order* (at paragraph 21) clearly states: "This adjustment spreads the difference between the PCI in effect during July 1995 and what it would have been under a full tariff year, over the next 11 months." The *1995 TRP Order* continues (*id.*): "LECs are required to make a reverse adjustment, taking out the PCI-Factor from the PCI in effect June 30, 1996, prior to calculating the proposed PCI for the 1996 tariff year."

Even MCI in its Petition for Clarification[35] states: "The adjustment for inflation less productivity are based on annual factors. When the Bureau delays the annual filing, the rate cut must be adjusted to reflect the amount foregone during the period between July 1, and the effective date of the new tariffs."

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[34] *See* Cost Support Material to be Filed with 1995 Annual Access Tariffs, Revisions to Tariff Review Plan for Price Cap Companies and Order, DA 95-823 (released April 14, 1995) at paragraphs 19-21 ("*1995 TRP Order*").

[35] MCI's Petition for Clarification, 1995 Annual Access Tariffs, United States Telephone Association Application for Waiver, DA 95-522, dated April 7, 1995, at 3.